

Testimony of Bradley E. Rock

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Financial Services

United States House of Representatives



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March 6, 2008

Chairman Frank and members of the Committee, my name is Bradley Rock, Chairman, President, and CEO of Bank of Smithtown, a \$1.2 billion community bank located in Smithtown, New York, founded in 1910. I am also the Chairman of the American Bankers Association (ABA). ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$12.7 trillion in assets and employ over 2 million men and women.

We appreciate, Mr. Chairman, the opportunity to comment on expanding the powers of credit unions. As always, these debates are filled with emotion on both sides. It is important to look beyond the rhetoric to focus on the reality of the credit union industry today. Certainly, there are many traditional credit unions that remain true to the original spirit of the credit union charter – meeting the needs of people of modest means. We must never forget that credit unions were established for this specific purpose. Serving people of small means is not a parenthetical duty; it is their legal focus and mission and is why credit unions have special federal privileges. The vast majority of credit unions continue to embody this statutory mission and we believe play an important role in our financial system.

Distinct from traditional credit unions, a new breed of credit unions has emerged that wants to serve a broad customer base, do complex business lending, and offer asset management services targeted at wealthier customers. These new-breed credit unions are virtually identical to taxpaying banks. As a practical matter, these new-breed credit unions are free to define and extend their membership as they please, allowing them to “cherry pick” the areas and individuals they will

include as customers. Thus, while the rhetoric is about serving low income people, the reality is that these new-breed credit unions have a license to seek out the wealthiest areas for branching at the expense of serving people who need them the most – those of modest means.

During this hearing, we will undoubtedly hear a lot from the National Credit Union Administration (NCUA) and credit union witnesses about the need for broader authority to serve underserved areas. We strongly urge the Committee to look at the harsh reality of what NCUA has already authorized in this area. It has **nothing** to do with serving the low-income people and **everything** to do with gutting any requirement for a common bond.

The reality is this: Congress meant for credit unions to have meaningful common bonds and provided a limited exception from the common bond to serve low-income neighborhoods with inadequate banking services. Instead, the NCUA has declared entire cities and counties to be underserved and allowed credit unions to open branches in high income areas with no requirement – **none** – that they serve low-income neighborhoods.

For example, all of Washington, D.C. has been declared underserved, and there is no requirement that there be any service to low-income people in the District. This is not theoretical: there are numerous examples of credit unions going into **only** the higher income districts of so-called underserved areas.

The reality is that if NCUA broadens the so-called underserved exemption, the common bond will be basically repealed. As NCUA declares more and more cities and counties underserved, all credit unions will be able to branch almost anywhere. With no requirement to put a branch in a low-income neighborhood, every credit union would be eligible to come to Washington, D.C., put a branch on K Street, where there are several branches on every block already, **and not make one loan to a low-income person.**

During this hearing, we will also hear about the loans to very small businesses that credit unions want to make but supposedly cannot. While the rhetoric speaks of serving the small business man or woman, the reality is that these credit unions are making **large** dollar loans to businesses. The truth is that these new-breed credit unions have made business lending a top priority as they seek to rapidly grow the institution – making loans that any taxpaying financial institution would want to make. The fact that some credit unions are hitting the Congressionally-mandated limits on business lending is because they are making these large loans – including those to businesses out of their market area.

Increasingly, business loans are being made to non-members. Aggressive new-breed credit unions have lending officers cold-calling on businesses and real estate developers, often outside their common bonds, who have no relationship whatsoever with the credit union. After the loan is agreed to, the credit union creates some back-channel way for the borrower to become a “member.” We urge this Committee to look at these loans and ask if this is what the credit union tax-exemption is for. Loans like:

- The \$30 million development loan in default for a luxury condo building by Eastern Financial Florida Credit Union.
- The loan for a luxury golf and condominium resort by Twin City Co-ops Federal Credit Union.
- Construction loans averaging \$10 million and all business loans averaging nearly \$3 million by Texans Credit Union.
- A \$10 million dollar loan commitment by the *California* credit union – Telesis Community Credit Union – to purchase an office tower in *Arkansas*.
- And above all, the millions of dollars in loans involving a failed and fraudulent *Florida* land deal that caused the recent failures of credit unions in *Colorado* and *Michigan*.

While the rhetoric is about the small mom-and-pop credit unions, the reality is that there are 123 credit unions that have over \$1 billion in assets. To put that in perspective, these credit unions are larger than 92 percent of the taxpaying banks in this country. Moreover, the traditional credit unions are being squeezed out by the invasive tactics of these growth-oriented credit unions. It is no surprise that nearly 2,100 credit unions have been absorbed into larger credit unions since the beginning of 2001.

Against a backdrop where non-traditional credit unions forsake the common bond in favor of fast growth, and where energies are diverted to favoring the well-off and businesses rather than serving people of modest means, it is no surprise that ABA opposes expansion of credit union powers and easing of credit union capital rules. To allow such expansion will only move the new breed of credit unions further and further away from their mandated mission.

And while the rhetoric suggests that without these changes there are no options for these institutions to grow and better serve their customers, the reality is that a very viable option is

available *today* through switching to a mutual savings bank charter – a route that some credit unions have already taken. This charter provides greater flexibility with the effective and experienced supervision of traditional banking regulators, while still preserving the mutual-member focus that credit unions find desirable.

Our statement addresses three important questions:

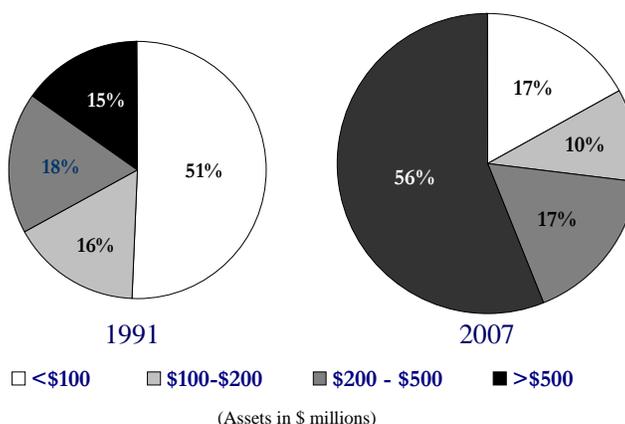
- *Are new-breed credit unions fulfilling their mandate to serve people of modest means?*
- *Are large business loans consistent with serving people of small means?*
- *At what point do some credit unions cease to be the type of institution deserving of preferential treatment?*

Are new-breed credit unions fulfilling their mandate to serve people of modest means?

As the credit union industry has matured, a new breed of institution has evolved that bears little resemblance to a traditional credit union. These “morphed” credit unions that seek out large commercial customers are a far cry from traditional credit unions which have remained true to their credit union mandate to serve people of small means. With the freedom to seek new markets virtually without restriction and to offer a full range of banking and financial products, many aggressive credit unions have leveraged their tax advantage to grow rapidly. ***There are now 123 credit unions each with assets greater than \$1 billion. There are 309 credit unions with assets of more than \$500 million each.***

These large, aggressive institutions increasingly dominate the industry, yet many still try to hide behind the veil of a “traditional credit union.” In spite of their metamorphosis into highly competitive financial institutions virtually indistinguishable from banks, these morphed credit unions continue to enjoy the tax-exempt status conferred on the industry when it was composed of small self-help organizations.

Large Credit Unions are Increasingly Dominating Industry Share (Based on Credit Unions Total Assets)



A good example of a credit union that has grown beyond its mission to serve people of modest means is Bethpage Federal Credit Union located on Long Island in New York. Bethpage, at **\$3 billion in assets**, is nearly three times larger than my bank and nearly five times larger than the median sized community bank headquartered on Long Island. It is clear from this ad for luxury home financing that its focus is often on wealthy individuals, not people of low and moderate income.

Are you in the market for a luxury home?

If so, you should know that Bethpage now offers Jumbo Mortgage loans up to \$1 million. Now, you can get those great Bethpage rates and low fees for your higher-priced home as well.

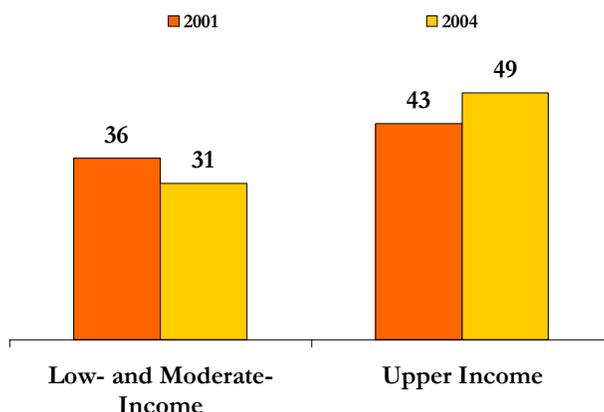
Whether you are buying a lavish estate or a modest cottage, when you finance your mortgage at Bethpage, you are now entitled to new ways to save:

- GE's Homebuyer PrivilegesSM – receive discounts on home-related products and services from Home Depot, GE Appliances, and ADT Security Systems and more! Visit www.bethpagefcu.com for more details and eligibility requirement.
- Land Bound Services, LLC – receive \$450 off title search (See coupon below for details).

Bethpage is not an isolated example. A recent study by the National Community Reinvestment Coalition found, “...that over a three-year time period, banks consistently outperformed credit unions in offering home loans to minorities, women, and low- and moderate-income borrowers in a majority of states.”

The Government Accountability Office (GAO) confirmed this as well. It found that credit unions lag banks in serving people of modest means. Using the Federal Reserve’s 2004 Survey of Consumer Finance data, GAO noted that only 31 percent of credit union customers are low- and moderate-income, while 41 percent of bank customers are low- and moderate-income. In fact, the percent of low- and moderate-income customers served by credit unions fell from 36 percent in 2001 to 31 percent in 2004.¹

Credit Union Service to Low- and Moderate-Income Households Declined



Source: GAO and Federal Reserve Survey of Consumer Finance

The fact that credit unions lag banks in serving low- and moderate-income individuals is also confirmed in states, such as Massachusetts, where state-chartered credit unions are subject to the Community Reinvestment Act. Between 2004 and 2007, 36 percent of all Massachusetts banks received either an outstanding or high-satisfactory rating. In comparison, only 13 percent of all state-chartered credit unions received either an outstanding or high-satisfactory rating from the same regulator.

¹ *Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements*. U.S. Government Accountability Office, November 2006. (GAO-07-29)

In recent years, many new-breed credit unions added “underserved” communities. While, on the surface, stretching geographic boundaries sounds like an excellent way to ensure that credit unions fulfill their mission of serving individuals of modest means, the reality is quite different. The problem begins with an extremely broad definition of what constitutes an underserved area by NCUA, so broad, in fact, that it includes *entire cities*. In fact, in recent years NCUA has approved the cities of Houston, Washington, D.C., Philadelphia, and Tucson as underserved communities. ***More importantly, NCUA poses no requirement on credit unions to actually serve the low- and moderate-income areas within those cities.***² Thus, a credit union could claim all of Washington, D.C. as an underserved community and set up shop in wealthy areas and completely ignore low- and moderate-income neighborhoods.

This is more than theory: HEW Federal Credit Union added all of Washington, D.C. as an underserved community. However, neither of its two branches is in a low-income or even moderate-income neighborhood. Robins Federal Credit Union (Warner Robins, GA), with almost \$1 billion in assets, added as an underserved area Clarke County, Georgia, located over 100 miles from its primary market in Macon. The branch it opened was in an upper income census tract in Athens, GA. So while the rhetoric sounds compelling, the reality is quite different and ignores the clear intent of Congress.

With no requirement or oversight that ensures credit unions claiming an underserved area actually reach out to the residents in the low-income areas, it is no surprise that expansion-minded credit unions have sought this option. In fact, the rate of approvals of so-called underserved areas has increased dramatically, ***growing from 40 to 641 approvals from 2000 to 2005***, according to the 2006 GAO study.³

Moreover, it took NCUA ***eight years*** after the Credit Union Membership Access Act of 1998 (CUMAA) to issue regulations requiring credit unions adding underserved areas to establish a service facility somewhere – ***anywhere*** – in the underserved area. Even then, it allowed credit unions ***two years*** to establish that physical presence. Even with this lenient requirement, many credit unions objected. For example, Roger Heacock, President and CEO of Black Hills Federal Credit Union, said in a 2006 comment letter to NCUA, “We strongly disagree with this change to require a physical presence in underserved areas. This may have been necessary years ago, but

² The GAO found that while NCUA moved quickly to approve expansions under the underserved area authority, NCUA did not develop indicators to determine if the credit unions’ services had, in fact, reached the underserved population in those expanded footprints. *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*. U.S. Government Accountability Office, October 2003 (GAO-04-91)

multiple electronic delivery channels now bring credit union services right into the home.”⁴

According to the U.S. Census Bureau, less than one-third of families earning less than \$25,000 per year had Internet access, while almost all families earning in excess of \$100,000 had Internet access. Once again, while the language suggests that underserved populations are being served, the reality can be completely different.

Are large business loans consistent with serving people of small means?

The new breed of credit unions is aggressively pursuing business customers through large commercial and real estate loans. A dramatic example of just how far these credit unions have gone is the financing of Thumper Pond. This luxury resort features a golf course, spa, waterpark, hotels, and a planned condominium community. Located in central Minnesota, the resort was financed by a large commercial loan made by Twin City Co-ops Federal Credit Union (Falcon Heights, MN). Not only is this far beyond any sensible definition of modest means, but the resort is located over 200 miles from the credit union’s headquarters. Is this the kind of loan that should be tax-subsidized?



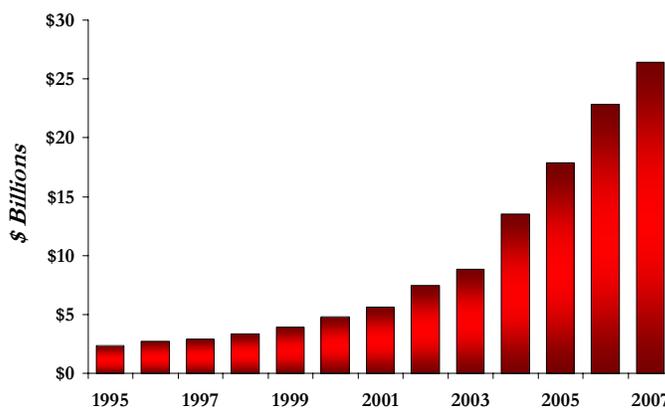
Now credit unions want to raise the cap on business lending to free up more resources to make even bigger loans. Their current tax-exempt status and lack of equivalent regulation have created huge competitive inequities in the local marketplace. Unfortunately, provisions to expand business lending, such as those in H.R. 1537, would further exacerbate these competitive inequities and raise safety and soundness concerns.

³ Ibid.

⁴Comment letter, Roger Heacock, Black Hills Federal Credit Union, March 29, 2006.

Business lending is the fastest growing line of business for credit unions. As of the end of 2007, credit unions held almost \$26.4 billion in business loans, *of which nearly \$5 billion was to nonmembers.*⁵ Today, business loans amount to 5 percent of all credit union loans – up from 1 percent in 2000.

NCUA: Credit Union Business Lending Soars



Source: NCUA

H.R. 1537 would increase credit unions' business lending authority to 20 percent of total assets from 12.25 percent, almost a doubling of their business lending authority. In addition, the bill excludes business loans under \$100,000 from the business lending limit, up from \$50,000 under current law, further masking the true amount of commercial lending engaged in by credit unions.⁶ ***Taken together these changes would grant credit unions more expansive commercial lending authority than taxing federal savings associations,*** which are limited to a flat 20 percent of total assets limitation, without the benefit of excluding certain business loan amounts from that cap and without the significant tax benefit.

Congress put these current limits in place to assure credit unions remained focused on individuals. In fact, the Senate Report implementing the Credit Union Membership Access Act of 1998, stated that the limits "...are intended to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, through the emphasis on consumer rather than business loans."⁷ How many loans

⁵ Oddly, NCUA in 2003 excluded these nonmember business loans from the Congressionally-mandated cap, helping to add impetus to these types of loans.

⁶ By raising the exclusion for business loans to \$100,000, H.R. 1537 encourages more lending at much larger dollar volumes and it would allow even more loans to be exempt from the special regulatory requirements for business lending, such as loan-to-value limitations and using experienced business-loan officers.

⁷ Senate Report 105-193, May 21, 1998, pp.9-10.

to low- and moderate-income individuals could be made instead of 20 percent of all assets being devoted to business loans in excess of \$100,000? Simply put, the focus on people of small means that was clearly enunciated in the preamble to the Federal Credit Union Act would be even further diminished – but the tax exemption for credit unions would not.

There is already plenty of evidence that business lending by large credit unions is often focused on larger loans to businesses that do not deserve tax-subsidized loans:

- Chetco Federal Credit Union (Harbor, OR) has become the “800 pound gorilla” in its local market, building a \$160 million business loan portfolio, with most loans in its “sweet spot” of \$100,000 to \$500,000; but could go as high as \$5 million.⁸
- Langley Federal Credit Union (Newport News, VA) at the end of 2007 had a total of \$96.8 million in *business loans to nonmembers*, representing 17.6 percent of all the outstanding loans.



- The average size of a business loan made by Digital Credit Union (Marlborough, MA) in 2007 was \$1 million.

⁸ “Twenty Years of Experience Helps Chetco FCU’s Business Lending Program Stay Innovative, Thwart Complacency” *Credit Union Times*, April 11, 2007, p. 18.

- Texans Credit Union (Richardson, TX) reported holding \$350 million in construction and development loans on its books at the end of 2007. The average size of a construction loan at Texans Credit Union was \$10 million. These are hardly loans to *small* businesses.
- Telesis Community Credit Union *located in California* made a commitment in 2006 to finance a \$10.2 million 24-story office building *located in Arkansas*. The average outstanding business loan at Telesis is \$680,000.
- Desert Schools FCU (Phoenix, AZ) announced it will provide commercial real estate loans up to \$7 million to finance or refinance commercial property, including professional offices, retail, warehouse and industrial zoned buildings.⁹



Desert Schools FCU
Phoenix, AZ
\$3 Billion

All of the above are loans for which any bank would compete. But the tax advantages enjoyed by credit unions make competition extremely difficult. A study by Virginia Commonwealth University professors Neil Murphy and Dennis O'Toole found that "...credit unions are enabled to offer a 67 basis point advantage in loan pricing and deposit pricing over banks as a direct result of the fact that credit unions do not pay state or federal taxes." The professors conclude: "In a highly competitive industry, the sixty-seven basis point government subsidy is substantial."¹⁰ The Federal Reserve Bank of Dallas agreed with the competitive threat: "Credit unions, aided by favorable legislation and regulation, have emerged as another particularly severe threat to small banks."¹¹

These are but a few examples of commercial lending by credit unions. They are not isolated cases. Many credit unions have commercial lending officers cold-calling on businesses that need million-dollar loans and are not in any way involved with the particular credit union.

⁹ "Desert Schools Finds Niche With Commercial Real Estate Loans" Credit Union Journal Daily, February 25, 2008.

¹⁰ Murphy, Neil and O'Toole, Dennis, *A Study of the Evolution and Growth of Credit Unions in Virginia: 1997-2002*, Virginia Commonwealth University, November, 2003.

¹¹ "Small Banks' Competitors Loom Large," Federal Reserve Bank of Dallas Southwest Economy, January/February, 2004, p. 10.

H.R. 1537 raises serious safety and soundness issues

As credit unions have aggressively pursued business lending options, business loan delinquencies have risen. For example, Eastern Financial Florida Credit Union (Miramar, FL), which appears to be above its aggregate business loan cap, started foreclosure proceedings against a real estate developer, Merco Group Inc. of Miami, on a \$30 million condo development loan for a 338-unit housing project overlooking Florida's Intercoastal Waterway. The credit union reported a loss of \$45 million in 2007.

The recent examples of two credit unions failures – Huron River Area Credit Union, Ann Arbor, MI, and Norlarco Credit Union, Fort Collins, CO – demonstrate the danger of credit unions leaving their core mission and aggressively pursuing business lending outside their markets. Both credit unions far exceeded the business lending cap and were lending to speculators thousands of miles away from their market areas. Appendix 3 provides details on the extent of the problems with these two credit unions and with their regulator which was supposed to supervise the risk that business lending posed.

In fact, GAO warned about the danger of business lending by credit unions. In its 2003 study, it concluded that, “[S]ince member business loans constitute only a small percentage of credit union lending, most NCUA examiners will not have significant experience looking at this type of lending activity. In contrast, banks and thrifts offer these loans to a much greater extent than credit unions and their regulators do have experience in this area.”¹² GAO was skeptical that NCUA was up to the challenge to ensuring that it is adequately prepared to monitor the expansion of credit union business lending.

In spite of the warnings and emerging evidence of problems with credit union business lending, H.R. 1537 weakens the capital regulation of credit unions. In fact, the capital provisions in H.R. 1537 are ***weaker than those applied to banks*** and do not reflect the true amount of capital on hand for credit unions to meet losses, especially during periods of financial stress. H.R. 1537 would lower the minimum capital “leverage ratio” requirement to be well capitalized from 7 percent to 5.25 percent. The current capital system was developed by Congress in 1998 because, in the

¹² *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*. General Accounting Office, October 2003 (GAO-04-91), p. 49.

words of the Treasury Department during the debate on the bill, NCUA's "...relevant statutes, regulations, and policies fall short of providing a system of prompt corrective action for credit unions. NCUA has no regulations or even formal guidelines for taking corrective action regarding a troubled credit union...."¹³ Moreover, the current capital rules were specifically imposed by Congress in order that credit unions would have the same type of capital requirements that were given to commercial banks and savings institutions in the aftermath of the savings and loan crisis.

Emil Henry, former Assistant Secretary of the Treasury for Financial Institutions, reiterated in 2006 the justification for current capital requirements:

There are also important differences in the capital structure of credit unions vis-a-vis other depository institutions. In general, credit unions can only raise equity capital by increasing retained earnings. This is an important feature that is grounded in the cooperative nature of credit unions. Thus, unlike other depository institutions, credit unions do not have access to other sources of capital to build a capital cushion when financial conditions are good.... [The] basic goal of a minimum leverage capital requirement is to encourage financial institutions to maintain sufficient capital levels so that the PCA requirements are not triggered.... Other factors that have been cited for imposing a higher leverage capital requirement surround the proper accounting for credit unions' investment in the NCUSIF [National Credit Union Share Insurance Fund] and their investments in corporate credit unions.

Also, Congress in 1998 required NCUA to establish a risk-based net worth requirement for "complex" credit unions. However, a 2004 GAO study found that only 8 percent of all federally-insured credit unions had been designated as complex by NCUA, subjecting them to a risk-based net worth requirement. ***This included none of the largest five credit unions and only one in the largest ten.***¹⁴

¹³ *Credit Unions*, United States Department of the Treasury, 1997, p. 76

¹⁴ *Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital*, U.S. Government Accountability Office, August 2004 (GAO-04-849).

At what point do some credit unions cease to be the type of institution deserving of preferential treatment?

As the credit union industry evolves, a blurring of the line between banks and credit unions has developed. In fact, a new breed of credit union has emerged that does not fulfill the traditional mission of serving people of small means, often focusing on above median-income people and commercial businesses, both of which have many options for financing and do not need tax-subsidized help. The common bond, where people can save and lend to one another, is often forsaken for rapid growth in members. Preserving the values of the traditional credit union charter has been a long-term priority for the Congress. Credit unions that seek greater product and service authority and want greater options to raise capital to support these expanded activities can and should choose a mutual savings bank charter, with the broader authority and experienced bank supervision that comes with it. This is the reason a straightforward, fair, and predictable conversion process from a credit union charter to a mutual savings bank charter is so important.

The evolution of credit unions raises important policy questions. Are new-breed credit unions fulfilling their mandate to serve people of modest means? Do these non-traditional credit unions qualify for their special treatment, despite the fact that they no longer serve the purposes of their charter? If these credit unions are not meeting the responsibilities Congress created for their charter, why should Congress give them more authority to expand business lending and other activities through the proposed Credit Union Regulatory Improvement Act to depart even further from their mandate? At what point do some credit unions cease to be the type of institution deserving of preferential treatment?

We would respectfully suggest that the answers all point to a credible, fair, workable process whereby a credit union that wants to exercise bank powers should be able to switch to a mutual savings bank charter. Without such a process, the only response to today's new breed of credit unions is to allow them to continue to abandon people of modest means while distorting the credit union charter into something unrecognizable by the original authors of the credit union concept.

Thank you, Mr. Chairman, for the opportunity to present the views of the American Bankers Association.

Appendix 1

Largest 25 Credit Union Business Lenders

September 30, 2007

Rank	Credit Union	City	State	Total Business Loans Outstanding	Average Size Business Loan Outstanding
1	Evangelical Christian	Brea	CA	\$1,071,206,000	\$926,648
2	Texans CU	Richardson	TX	801,092,000	2,923,693
3	Melrose	Briarwood	NY	625,434,000	153,480
4	Patelco	San Francisco	CA	592,879,000	1,291,675
5	America First	Ogden	UT	497,515,000	999,026
6	Lockheed FCU	Burbank	CA	352,627,000	2,086,550
7	San Diego County CU	San Diego	CA	335,871,000	511,219
8	Telesis Community	Chatsworth	CA	330,593,000	683,043
9	Citizens Equity First	Peoria	IL	321,185,000	399,981
10	Kinecta	Manhattan Beach	CA	317,098,000	1,187,632
11	Premier America CU	Chatsworth	CA	309,001,000	1,437,213
12	Digital	Marlborough	MA	308,678,000	738,464
13	Progressive	New York	NY	301,912,000	130,022
14	State Employees CU	Raleigh	NC	286,740,000	76,894
15	Christian Community	Covina	CA	280,425,000	520,269
16	Royal CU	Eau Claire	WI	263,089,000	312,828
17	Eastern Financial Florida	Miramar	FL	255,879,000	1,421,550
18	Orange County Teachers FCU	Santa Ana	CA	248,699,000	322,566
19	Mountain America	W. Jordan	UT	247,903,000	511,140
20	Beacon	Wabash	IN	239,544,000	117,827
21	Whitefish CU Association	Whitefish	MT	238,091,000	333,928
22	Coastal FCU	Raleigh	NC	234,627,000	1,203,215
23	Central Minnesota	Melrose	MN	225,574,000	98,762
24	Farmers Insurance Group FCU	Los Angeles	CA	218,397,000	97,804
25	Huron River Area CU	Ann Arbor	MI	198,295,000	246,329

Appendix 2
Largest 25 Credit Unions Making Business Loans to *Non-Members*
September 30, 2007

Rank	Credit Union	City	State	Non-Member Business Loans
1	Patelco	San Francisco	CA	\$569,879,000
2	Premier America CU	Chatsworth	CA	199,054,000
3	Texans CU	Richardson	TX	175,049,000
4	Orange County Teachers FCU	Santa Ana	CA	154,784,000
5	Western FCU	Manhattan Beach	CA	125,528,000
6	Credit Union of Texas	Dallas	TX	121,461,000
7	Bethpage FCU	Bethpage	NY	96,423,000
8	Langley	Newport News	VA	92,258,000
9	Safe	N. Highlands	CA	85,913,000
10	Lockheed FCU	Burbank	CA	84,644,000
11	Kinecta	Manhattan Beach	CA	84,359,000
12	Keypoint	Santa Clara	CA	80,732,000
13	Citizensfirst CU	Oshkosh	WI	79,641,000
14	Travis	Vacaville	CA	76,209,000
15	Caltech Employees FCU	La Cañada	CA	74,048,000
16	Fox Communities CU	Appleton	WI	70,481,000
17	Financial Partners	Downey	CA	68,817,000
18	Open Engineers Local #3 FCU	Livermore	CA	65,656,000
19	California Coast	San Diego	CA	64,652,000
20	America First	Ogden	UT	63,005,000
21	United Services of America FCU	San Diego	CA	62,142,000
22	Nuvision	Huntington Beach	CA	62,031,000
23	Allegacy	Winston-Salem	NC	55,254,000
24	Southland	Downey	CA	54,710,000
25	First Financial	Albuquerque	NM	53,024,000

Appendix 3

Business Lending and the Failure of Huron River Area and Norlarco Credit Unions

Due to significant losses from expansive business lending programs, two credit unions recently failed. Huron River Area Credit Union was a \$268 million Ann Arbor, Michigan institution and Norlarco Credit Union was a \$334 million Fort Collins, Colorado institution.

The experience of these credit unions validates the wisdom of Congress when it imposed specific business lending limits on credit unions in 1998 and raises several important policy questions. First, were these credit unions adhering to the business lending cap? Second, did their out-of-market business lending programs expose them to too much risk? Third, did the people these credit unions made loans to have the necessary affinity to qualify for credit union membership? Finally, does the experience of these credit unions suggest a lack of adequate oversight in the regulatory process?

Did These Credit Unions Adhere to the Business Loan Limit?

When Congress enacted the Credit Union Membership Access Act (CUMAA) in 1998, it specifically limited business lending authority of credit unions to 12.25 percent of assets. The intent of this restriction was to “ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, through an emphasis on consumer rather than business loans.”¹⁵ Both Norlarco and Huron River far exceeded the 12.25 percent lending cap.

Business Lending by Norlarco

In the first half of 2007, the member business loan portfolio of Norlarco increased from \$38 million to \$78 million. However, in the call reports that credit unions are required to file with their regulator each quarter, Norlarco reported originating only \$2.3 million in new business loans for that period, even though its member business loan portfolio had more than doubled. When asked by a local newspaper whether the credit union deliberately mischaracterized loans in order to remain

¹⁵ S. Rep. No. 105-193, (1998).

under the federal lending cap, Bob Hamer, CEO of Norlarco, stated “No. There was a deliberate attempt to make as many business loans as we could.”¹⁶

Furthermore, the \$78 million in business loans that Norlarco had in June represented nearly 23 percent of the credit union’s assets – nearly double the congressionally mandated limit.

Business Lending by Huron River

Huron River Area CU reported only four member business loans worth \$8.6 million on its books as of December 2006. Yet after the credit union was placed into conservatorship¹⁷ in February 2007, its financial statements were restated. The restated call reports indicate that Huron River Area CU actually had 785 member business loans worth \$139 million as of December 2006. Further revisions show that by the end of June, member business loans had increased to \$193 million, with \$185 million in construction and development loans.

The restated call reports for December 2006 show that slightly more than 37 percent of the credit union’s assets were in business loans at that time. By the middle of 2007, this figure had increased to roughly 72 percent – well above the legal business loan cap of 12.25 percent.

Did Their Business Lending Programs Expose Them to Too Much Risk?

Unlike secure lending to individuals, business lending carries inherently more risk. In fact, the delinquency rate on credit union business loans is more than one-and-a-half times higher than the delinquency rate on the overall portfolio of credit unions. Moreover, business loans are typically much larger than consumer loans, requiring more stringent monitoring due to their potential for greater loss. The risks associated with business lending are compounded when loans are made to out-of-market customers with no prior relationship with or connection to the credit union and in a market that is unfamiliar to the credit union. The ultimate losses experienced by both Norlarco and Huron River indicate that their business lending programs exposed them to a high level of risk which was compounded by the fact that these loans were out-of-market and were not adequately underwritten or monitored.

¹⁶ Robert Moore, “Norlarco Exceeds Federal Limit for Business Loans,” *The Coloradoan*, September 21, 2007.

¹⁷ In a conservatorship, the NCUA Board takes immediate possession of the business and assets of a credit union and takes on all the powers of the credit union members, directors, and officers until the Board determines that the credit union is in strong enough financial condition to continue its business, or the credit union is liquidated and its assets are sold off. See 12 U.S.C. § 1786.

Out-of-Market Lending by Norlarco and Huron River

According to the financial records of Norlarco and Huron River, it appears that both credit unions were involved in making construction and land development loans in southwest Florida – well outside each of their local market areas.

NCUA records indicate that Norlarco had 1,035 loans worth \$238 million in Lee County Florida. Huron River was also actively making loans in Lee County. While the dollar volume of these loans has not been made public, it is believed to be in the hundreds of millions. Huron River posted a \$59 million loss during the first six months of 2007 after writing off \$62 million related to potentially bad loans. The *Credit Union Journal* has reported that NCUA is holding at least \$468 million in loans made by these two credit unions (and possibly a third) in Lee County, Florida.

The ability to monitor out-of-market business loans requires considerable resources, particularly when there is no physical presence in the market. It also requires considerable oversight by regulators to assure adequate compliance with federal and state law regarding underwriting standards, loan monitoring standards, and reporting accuracy.

Did the Credit Unions Adhere to the Common Bond Requirement?

The traditional philosophy underpinning credit unions is based on the idea that the deposits of members are used to provide those self-same members with loans, and the close affiliation among the members – their common bond – creates an incentive for each member to repay their obligation so that the other members do not suffer a loss. When Congress enacted CUMAA in 1998, it found that “a meaningful affinity and bond among [credit union] members . . . is essential to the fulfillment of the public mission of credit unions.”¹⁸ With regard to Norlarco and Huron River, both credit unions found ways to “qualify” borrowers who would not have had any natural affinity with either institution.

Norlarco Investors

Out-of-state investors were able to qualify for loans from Norlarco by claiming association with one of three non-profit organizations affiliated with the credit union. These include the Rocky Mountain Bird Observatory, the Boys and Girls Club of Larimer County, and Legacy Land Trust.

¹⁸ United States. Cong. Senate. 105th Congress, H.R. 1151, The Credit Union Membership Access Act, enrolled by both the House and Senate; 28 July 1998.

Such loose affiliations are often used by credit unions to meet the legal requirement for membership, but they circumvent the common bond principle. Basically, these types of associations undermine completely the concept of a common bond, as anyone – individual or business – can join.

It is also relatively common for credit unions to simply take an applicant's word when determining eligibility. According to Bob Hamer, President and CEO of Norlarco, "We usually ask them how they believe they can be a member in their application. If they tell us, we don't assume they're lying. We don't verify that any of that is true."¹⁹ State regulators take claims of eligibility at face value.

As a result of their involvement with the Florida land deals, many of Norlarco's members are pulling their money out of the credit union. Ron Phillips, economics professor at Colorado State University, has stated that many of his colleagues are withdrawing their money from Norlarco, the university's credit union, "Not because it's losing money, but because it's making loans in Florida . . . They are not using the money locally."²⁰

Huron River Investors

It is not clear how investors qualified for loans from Huron River. Michigan law restricts credit union lending to members only and loans can be for out-of-state purposes as long as they are to members. Significantly, Huron River has been named in a lawsuit alleging real estate fraud and according to at least one report, there is no evidence indicating whether any of the more than 50 plaintiffs nationwide are members of the credit union, though at least one couple hails from Michigan.²¹

Was There Adequate Regulatory Oversight of These Credit Unions?

State supervisors have primary responsibility for examining state-chartered credit unions, but NCUA has authority to examine any state-chartered credit unions that are insured through the National Credit Union Share Insurance Fund (NCUSIF). NCUA also has the authority to place any insured credit union that encounters financial difficulties into conservatorship.²² The overwhelming

¹⁹ Pat Ferrier, "Non-Members Got Loans From Norlarco," *The Coloradoan*, August 28, 2007.

²⁰ Pat Ferrier, "Lawsuits Fly Over Norlarco's Florida Loans," *The Coloradoan*, August 23, 2007.

²¹ Stefanie Murray, "Lawsuit Accuses Troubled Credit Union of Fraud," *The Ann Arbor News*, August 30, 2007.

²² In the case of state-chartered, federally-insured credit unions, the NCUA must receive written approval of the reasons for conservatorship by the state regulator unless the reasons are due to serious undercapitalization of the credit union, in which case the NCUA is only required to consult with the state regulator. See 12 U.S.C. § 1786(h)(1).

majority of state-chartered credit unions have insurance through the NCUSIF and both Norlarco and Huron River are state-chartered credit unions with NCUSIF insurance.

According to a 2003 study by GAO, many state credit union regulators suffer from high examiner turnover and lack sufficient resources and expertise to ensure adequate oversight of state-chartered credit unions.²³ The report further states that in cases where state examiners lacked examiner resources or expertise, NCUA provided its own staff to ensure proper examination, and also conducted joint examinations of selected state-chartered credit unions to assess the risk they posed to NCUSIF.

State regulators in Colorado and Michigan did not catch the under-reporting of business loans and did not adequately address the risks associated with out-of-market business lending. Moreover, in the case of Norlarco, when the losses were discovered and the institution failed, the takeover of the credit union was not disclosed to the public.

The Failure of Norlarco

As previously noted, Norlarco reported originating only \$2.3 million in business loans for the first half of 2007, even though its business loan portfolio had actually jumped from \$38 million to \$78 million. The Colorado regulator failed to catch the under-reporting of business loans by Norlarco.

Furthermore, the fact that Norlarco was in danger of failing and had been placed into conservatorship was originally kept from the public. The credit union was placed into conservatorship in May by the state regulators and was subsequently taken over by NCUA in July. However, the public did not become aware of the credit union's troubles until August 22 when *The Coloradoan*, a local newspaper in Fort Collins, broke the story.

Though Colorado law bars state regulators from disclosing the failure of a state-chartered credit union, NCUA is not under a similar obligation. The Federal Credit Union Act does not specifically require NCUA to notify credit union members, or the public at large, that their credit union has been placed into conservatorship, but nothing in the Act bars NCUA from doing so.

Reportedly, the decision not to announce the conservatorship was made jointly by NCUA and the Colorado regulator with the apparent intention of preventing a mass withdrawal of deposits from the credit union. However, the experience of the Federal Deposit Insurance Corporation

²³ GAO Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management, GAO-04-91, October 2003.

(FDIC) in the late 1980s and early 1990s is that allowing word of a failure to slowly leak out is more likely to be contagious and lead to a run than informing customers about the status of their financial institution.

The Failure of Huron River

Similar to Norlarco, Huron River also under-reported the amount of business lending it was engaged in and the state regulator failed to recognize the severity of the situation. As previously noted, Huron River restated its call reports after being placed into conservatorship clarifying that it actually had \$139 million in business loans as of December 2006 and not merely \$8.6 million as first reported.

However, unlike Norlarco, the public was made aware that Huron River was placed into conservatorship almost immediately. Michigan law does not bar state regulators from disclosing the failure of a credit union and the decision was made to let the public know.

Considering that both Huron River and Norlarco were placed into conservatorship because of non-performing loans stemming from the same Florida development project, it would seem that the implications of placing either credit union into conservatorship would be the same. Thus, if keeping disclosure of conservatorship is truly necessary to prevent a run on member deposits, NCUA should arguably want to employ this principle across the board.